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Grenada: Third Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Requests for Modification of Quantitative Performance Criterion and Augmentation, and Financing Assurances Review—Staff Report; Staff Supplement; and Press Release on the Executive Board Discussion

In the context of the third review under the Poverty Reduction and Growth Facility, requests for modification of quantitative performance criterion and augmentation, and the financing assurances review for Grenada, the following documents have been released and are included in this package:

- The staff report for the Third Review Under the Poverty Reduction and Growth Facility, Requests for Modification of Quantitative Performance Criterion and Augmentation, and Financing Assurances Review, prepared by a staff team of the IMF, following discussions that ended on March 25, 2009, with the officials of Grenada on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 20, 2009. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A staff supplement on the Debt Sustainability Analysis.

- A Press Release summarizing the views of the Executive Board as expressed during its June 3, 2009, discussion of the staff report that completed the request.

The document listed below will be separately released.

Letter of Intent sent to the IMF by the authorities of Grenada.*
Supplementary Memorandum of Economic Policies by the authorities of Grenada*
Supplementary Technical Memorandum of Understanding*
*Also included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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GRENADA

Third Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Requests for Modification of Quantitative Performance Criterion and Augmentation, and Financing Assurances Review

Prepared by Western Hemisphere Department
(In consultation with other departments)

Approved by José Fajgenbaum (WHD) and Aasim Husain (SPR)

May 20, 2009

Context: The global slowdown and financial turmoil have negatively affected tourism receipts, FDI, and remittances. The banking system has remained resilient thus far, but the intervention of the Trinidad and Tobago-based CL Financial Group has increased financial sector uncertainty. Growth is projected to slow markedly in 2009, as almost all FDI-financed tourism projects are on hold.

Arrangement: On April 17, 2006, the Executive Board approved a PRGF Arrangement for SDR 10.53 million (90 percent of quota). In July 2008, the Board completed the first program review, augmented access to 102.5 percent of quota to help mitigate the impact of food and fuel price shocks, and extended the arrangement by one year to April 16, 2010. The second review was completed in December 2008.

Program performance: All end-2008 quantitative targets were met. Meeting structural benchmarks on submitting investment legislation and a new Excise Bill and on completing a Country Poverty Assessment has been delayed by the time required to consult stakeholders, to finalize the list of excisable goods, and to complete the technical work and drafting, respectively.

Review: In the attached Letter of Intent and Supplementary Memorandum of Economic Policies, the authorities elaborate on their policies for 2009 and propose quantitative performance criteria and structural benchmarks through 2009. They also request completion of the review, modification of the end-June 2009 performance criterion on the primary balance (by 1.4 percent of GDP), and augmentation of access to 140 percent of quota, with an additional SDR 4.39 million available upon completion of the third and fourth reviews.

Missions: A mission visited St. George's during March 16–25, 2009 and met with Prime Minister Thomas, Minister of Finance Burke, Permanent Secretary Antoine, other senior officials, and private sector representatives. The mission overlapped with a mission conducting the ECCU Common Policies discussions, and comprised Ms. Pattillo (Head), Messrs. Monroe, Kang (all WHD), and Das (SPR), with input from Ms. Kaltani (SPR).

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EXECUTIVE SUMMARY

The global economic slowdown and financial turmoil are markedly slowing economic activity, chiefly through a weakening of tourism receipts, FDI, and remittances. Almost all FDI-financed tourism projects are on hold. Real GDP is projected to decline by 0.7 percent in 2009 and to recover slightly in 2010. Inflation is projected to fall to 2.1 percent by the end of 2009, as declines in world food and fuel prices feed through. Commercial banks have remained resilient, but the intervention of the Trinidad and Tobago-based CL Financial Group is increasing financial sector uncertainty.

All end-December 2008 quantitative targets were met, reflecting the authorities' strong remedial fiscal measures in the second half of 2008. In particular, the authorities met the target on the primary deficit excluding grants, which fell from 5.1 percent of GDP in the first half to 2.4 percent of GDP in the second half of the year. They reduced arrears older than 60 days to only EC$8.4 million (0.5 percent of GDP), meeting this performance criterion by a significant margin. Capital expenditure of 12.5 percent of GDP in 2008 was higher than the programmed level of 10.7 percent of GDP, but did fall by 3 percentage points of GDP from the first to the second half of 2008.

Meeting some structural benchmarks is taking longer than envisaged. The performance criterion on initiating reorganization or liquidation of Capital Bank was met in November 2008. A Debt Management Unit was established in January 2009. However, benchmarks on submitting investment incentives legislation and completing the Country Poverty Assessment are not expected to be met until end-May and August 2009 respectively. The government has announced an introduction date for the VAT of February 1, 2010. Preparations are proceeding well, aided by CARTAC technical assistance; the authorities submitted the VAT Bill to Parliament in April on schedule, and plan to submit the Excise Bill in August 2009 rather than in April as previously envisaged.

The revised fiscal program envisages a primary deficit of 4.4 percent of GDP in 2009. Due to the global slowdown, shortfalls are expected in trade-related taxes, grants, and divestment proceeds, and the government has adjusted primarily by revising capital spending downward from 10 to 8.9 percent of GDP. To address the impact of the slowdown, capital projects that provide the greatest economic stimulus will be accelerated, while transfers to vulnerable groups will increase. Despite the spending cuts, the original end-June 2009 primary balance target is no longer attainable.

The government intends to continue and accelerate structural reforms, while sharpening their focus. The government will appoint a separate Registrar of Companies as a key step in their action plan to improve Doing Business Indicators. They are also pushing forward with steps to prepare for VAT introduction, to implement a customs Fraud Control Plan, and to improve the efficiency of public procurement. Completion of the Country Poverty Assessment is an essential input to preparing a full PRSP.

The government may seek a US$50–80 million (7–12 percent of GDP) concessional loan from the Export-Import Bank of China to build a luxury hotel in a joint venture. With the already high debt level (108.6 percent of GDP at end-2008), the loan could jeopardize the key objective of reducing debt and is not accommodated within the program ceiling on bilateral concessional debt.

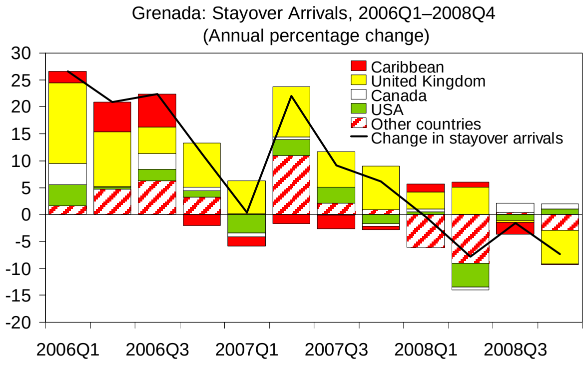
Program risks are significant. The impact of financial turmoil and the global economic slowdown on tourism, FDI, growth, revenue, and grants could be stronger than expected. In addition, the intervention of CL Financial Group could affect financial sector confidence, and the possible loan from China would undermine debt reduction objectives.

I. Recent Developments and Outlook

1. **Grenada has made good progress with its home-grown economic program, which was launched with the 2006 budget and is supported by the PRGF.** However, the sharp slowdown in global growth and the continuing global financial crisis have had a large adverse impact on growth, the external position, and fiscal revenue. As a result, it has been necessary to revise the policy framework for 2009 to address these challenges, while maintaining the key objectives of reducing public debt, reinvigorating growth through structural reforms, reducing vulnerabilities, and furthering the nation's social development agenda.

A. Recent Developments

2. **Economic growth has declined sharply reflecting the global slowdown.** Real GDP growth slowed to 0.3 percent in 2008, from 4.5 percent in 2007, as tourism receipts and FDI weakened. Tourist stayover arrivals declined by about 5 percent in 2008. Almost all FDI-financed tourism investment projects have been put on hold due to financing difficulties, and as a result, the construction sector, which accounted for about 10 percent of real GDP in 2007, contracted by more than 14 percent in 2008. Some large employers and many hotels have laid off or are rotating staff.[1]

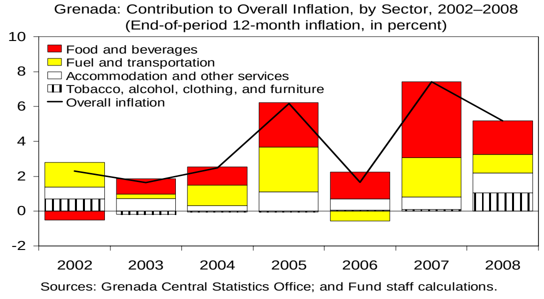


Sources: ECCB; and Fund staff calculations.

3. **The external current account deficit increased slightly in 2008 due to high world fuel and food prices and lower tourism receipts and exports, which were partially offset by increased official grants.** The real effective exchange rate appreciated by 6½ percent through December 2008, reflecting the appreciation of the U.S. dollar, to which the Eastern Caribbean dollar is pegged, against other major currencies.

[1] The authorities estimate that the unemployment rate was around 25 percent in 2008 (based on preliminary data from the Country Poverty Assessment), and they project that it will rise significantly in 2009.

4. **Inflation declined to 2.8 percent by March 2009, after peaking at 9.3 percent in July 2008.** The inflation path reflects the trajectory of world fuel and food prices and the dominant weight of these items in the CPI. Core inflation (excluding food and energy) was only 1.5 percent through March 2009 (Figure 1).



5. **The difficulties of the Trinidad and Tobago-based CL Financial Group have increased financial sector uncertainty.** The group has a number of linkages to the Grenadian economy, including the presence of two insurance subsidiaries which have been offering deposit-like products to individuals and public and private entities, and majority ownership of Republic Bank Limited.[2] There is some public concern about delays in payments on policies, and the government has asked policy holders to avoid seeking early surrenders. The exposure of the insurance subsidiaries to policy and deposit holders in the Eastern Caribbean Currency Union (ECCU) region amounts to about EC$2 billion (around 15 percent of ECCU GDP).[3] This development is worrisome in the context of other events which have adversely affected financial sector confidence, including the failure of Capital Bank, an unregulated bank, and of SGL Holdings, an investment scheme promising unusually high returns. Grenada appears not to have any direct exposure to the Stanford Financial Group.

6. **The banking system, which is dominated by subsidiaries of international banks, has remained resilient.** Private sector credit growth slowed to 9.3 percent at end-February 2009, reflecting weaker economic activity. As of end-December 2008, the ratio of nonperforming loans (NPLs) to total loans remained low at 3.5 percent, and liquidity and capital adequacy ratios were also adequate (Figure 2). However, banks report increases in NPL ratios in the first quarter of 2009, as some nonresident and resident borrowers are experiencing repayment difficulties.

7. **The government increased the frequency of adjustments in retail fuel prices from an eight-week to a four-week cycle in order to reduce the magnitude of each adjustment.** The government also recently cleared arrears to fuel importers resulting from incomplete passthrough of world fuel prices in 2007–08 through an arrangement under which 50 percent of the fuel tax was remitted back to importers.

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[2] There was a mini-run on Republic Bank's Carriacou branch after Trinidad and Tobago announced the intervention of CL Financial Group, but the situation quickly stabilized.

[3] See *Eastern Caribbean Currency Union—Staff Report for the 2009 Discussion on Common Policies of Member Countries*, (IMF Country Report No. 09/175).

B. Outlook

8. **The global economic slowdown has severely weakened Grenada's economic outlook.** Real GDP is projected to decline by 0.7 percent in 2009, lower than the earlier projection of 1.6 percent growth, and the risks are to the downside.[4] Stayover arrivals are expected to decline further, by about 10 percent, and remittances are likely to slow down sharply. Difficulties in securing financing for major projects will lower FDI inflows markedly, resulting in a further sharp contraction of the construction industry. Annual inflation is projected to fall to 2.1 percent by end-2009 as lower world fuel and food prices are passed through. The current account deficit is expected to narrow sharply, notwithstanding a decline in tourism receipts, reflecting lower fuel and food prices and lower FDI-related imports, while the overall balance is projected to deteriorate significantly. Although the banking sector is expected to remain resilient, there is continuing uncertainty over how developments with CL Financial Group will affect Grenada.

II. Performance Under the Program

9. **All end-December 2008 quantitative performance criteria were met, reflecting the strong remedial measures put in place in the second half of 2008.** In particular, the authorities met the target on the primary deficit excluding grants, which fell from EC$88 million (5.1 percent of GDP) in the first half of 2008 to EC$41 million (2.4 percent of GDP) in the second half.[5] A major effort was made to lower expenditure arrears, which fell from EC$33 million (1.9 percent of GDP) at end-June 2008, before the change in government, to EC$9.7 million (0.6 percent of GDP) at end-December 2008. Furthermore, the government was able to roll over late principal payments, which helped to reduce arrears older than 60 days to only EC$8.4 million (0.5 percent of GDP), meeting this performance criterion by a significant margin.

10. **A major component of the fiscal adjustment was the reduction in capital expenditure by 3 percentage points of GDP in the second half of the year.** This expenditure category accounts for one-third of total spending and has been difficult to control. Despite this adjustment, capital expenditure of EC$215 million (12.5 percent of GDP) in 2008 was still higher than the programmed EC$184 million (10.7 percent of GDP). Revenue in the second half of the year exceeded projections by 0.6 percent of GDP, due to the strong performance of income and profits taxes.

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[4] The sustained growth of the offshore university and the agriculture sector are expected to support output growth, though the weights of those sectors in real GDP are relatively small.

[5] The target is measured below the line; the improvement measured above the line was not as large.

11. **Meeting some structural benchmarks is taking longer than envisaged.** The structural performance criterion on initiating reorganization or liquidation of Capital Bank was met in November 2008, which is a step toward resolving a longstanding financial sector issue. The bank's owner was arrested in March 2009 on charges of fraudulent breach of trust. A Debt Management Unit was established in the Ministry of Finance in January 2009 to improve the effectiveness of and develop a strategy for debt management. The authorities submitted the new VAT Bill to Parliament in April, and plan to submit the Excise Bill in August 2009 rather than in April as previously envisaged. The benchmark on submitting investment incentives legislation[6] was missed due to the time needed to consult stakeholders, while the benchmark on completing a Country Poverty Assessment (CPA) has been delayed reflecting the time needed to complete the technical work and drafting of the report. These measures are important to improve the business environment and to lay the groundwork for a full PRSP, respectively. A tax holiday was issued to a call center in February 2008.[7]

Status of Structural Benchmarks Under the Program

	Target Date	Status
Reorganize or initiate liquidation of Capital Bank	November 2008	Performance criterion. Met
Submit investment incentives legislation	December 2008	Benchmark. Not met
Complete the Country Poverty Assessment	December 2008	Benchmark. Not met
Establish a Debt Management Unit	February 2009	Benchmark. Met
Submit new VAT and Excise Bills	April 2009	Benchmark. Partially met

III. POLICIES FOR 2009

12. **The government's economic strategy is focused on coping with the shock to tourism and FDI while laying the groundwork for broad-based growth.** Policy discussions focused on adapting the fiscal framework to reflect the reality of reduced revenue and financing. Staff supported the authorities' planned measures to address the shock, but stressed that fiscal and debt dynamics should be monitored closely to ensure a sustainable trajectory. Other key policy issues discussed were fiscal and institutional reforms, plans to enhance the business environment, and financial sector vulnerabilities.

A. Fiscal Policies and Debt Sustainability

13. **The outlook for budgetary financing in 2009 has deteriorated.** Divestment proceeds from a luxury hotel project—the expected main financing source for the 2009 budget—will not materialize this year. The projection for trade-related taxes has been revised downward by 19 percent, which is in line with the shortfall in the first quarter of

[6] LEG has provided technical assistance on drafting.

[7] Refraining from issuing further tax holidays was a benchmark for the first review, which was missed.

2009. In addition, PetroCaribe-related grants will also fall sharply reflecting: (i) lower fuel prices; (ii) a lower share of imports financed under the agreement when the diesel price is below US$100 per barrel; and (iii) the decision to transfer 35 percent rather than 65 percent of amounts financed to the budget as grants.[8]

14. **The government has adopted a two-pronged strategy to address the shock to tourism and FDI, which emphasizes the need for early intervention and fiscal adjustment:**

- First, within a tighter budget envelope, capital spending programs providing the greatest economic stimulus will be accelerated. The Cabinet has selected a list of priority government and state-owned enterprise projects, taking into account employment generation potential, geographic distribution, and economic visibility. The government will also seek to expedite approvals needed for private sector projects. Reflecting financing constraints, including limited divestment proceeds, the capital spending target has been lowered to EC$160 million (8.9 percent of GDP).[9] The government will also shift from a system of quarterly to monthly allocations to ministries as an expenditure control mechanism to help ensure that the target is met.

- Second, the government will undertake targeted social spending to mitigate the impact of the economic slowdown on the employment and incomes of vulnerable groups.[10] The public assistance program has been streamlined to remove ineligible individuals, while new qualified persons have been added, and a road maintenance program will provide direct support to poor households. These initiatives are expected to cost EC$6 million (0.3 percent of GDP), which is incorporated in the fiscal program.

The mission supported the strategy of accelerating high impact capital spending within a tighter budget envelope, in light of the limited room for maneuver. It also welcomed the

[8] Staff had previously recommended that the state-owned company PetroCaribe Grenada Ltd. increase the share of PetroCaribe financing set aside in a special account to pay debt service; the larger share now being set aside will be more than sufficient. The mission noted the need to limit government exposure of the special account.

[9] Based on preliminary data, capital spending in the first quarter slowed sharply to EC$23 million or EC$92 million (5.1 percent of GDP) at an annual rate, reflecting the tight financing situation.

[10] Together with the World Bank, the authorities are developing an aggregate measure of social spending. Preliminary Fund staff calculations indicate that recurrent social spending in 2009 (including transfers to households, education, health, housing, community development, and youth programs) is expected to remain around the same share of GDP as in 2008, while social sector capital project spending will decline, in line with the overall lower capital expenditure as a share of GDP and reflecting the authorities' efforts to improve the efficiency of social spending.

progress in streamlining transfers, and the emphasis on targeted relief to vulnerable groups using the tools available.

Fiscal Developments in 2006–09

(In percent of GDP)

	2006	2007	2008					2009	
			First Half	Second Half		Full year			
	Actual	Actual	Prel.	Prog.	Prel.	Prog.	Prel.	Prog.	Proj.
Total revenue and grants	**33.6**	**27.2**	**15.1**	**15.7**	**16.2**	**30.8**	**31.3**	**30.7**	**26.7**
Revenue	24.9	26.1	13.5	12.8	13.4	26.3	26.9	27.0	24.2
Grants	8.7	1.1	1.6	3.0	2.7	4.5	4.3	3.6	2.5
Total expenditure	**40.0**	**35.3**	**19.8**	**15.3**	**17.2**	**35.1**	**37.0**	**33.0**	**31.6**
Current expenditure	21.2	21.7	12.0	12.4	12.5	24.4	24.5	23.0	22.7
Of which									
Interest	2.1	2.3	1.2	1.5	1.4	2.7	2.6	3.1	3.0
Capital expenditure	18.8	13.6	7.8	2.9	4.7	10.7	12.5	10.0	8.9
Primary balance (excluding grants) 1/	**-13.0**	**-6.9**	**-5.1**	**-1.0**	**-2.4**	**-6.1**	**-7.5**	**-2.9**	**-4.4**
Overall balance (including grants) 1/	**-6.4**	**-8.2**	**-4.7**	**0.4**	**-1.0**	**-4.3**	**-5.7**	**-2.4**	**-4.9**

Sources: Ministry of Finance; and Fund staff estimates and projections.
1/ Measured above the line.

15. **In addition, the government is considering providing temporary assistance to support the tourism sector.**[11] This could include increasing the budget for marketing and airline support by up to EC$10 million (0.6 percent of GDP), and the provision of temporary tax relief on hotels' food imports. The mission recommended that the government choose measures that are time bound and have limited fiscal impact. The marketing and airline support, which the authorities classify as capital expenditure, would need to be accommodated by cutting some other projects.

16. **The government recognizes the seriousness of fiscal challenges in 2009, and is undertaking adjustment measures:**

- On the revenue side: maintaining the specific fuel tax of EC$3 per gallon; and enhancing use of tax enforcement measures, including garnishing income and seizing assets, following completion of the tax amnesty at end-April.[12] The mission noted the potential adverse impact of any further extensions to the tax amnesty on the credibility of the tax system.

[11] A recent communiqué of the Organization of the Eastern Caribbean States (OECS) and the Eastern Caribbean Central Bank (ECCB) Monetary Council supported the introduction of measures to provide short-term relief. Grenada may face pressure to match incentives provided by its regional competitors.

[12] The tax amnesty was extended from end-March to end-April only for taxpayers who had already applied by the end of March. It has yielded EC$7.5 million, nearly EC$9 million less than targeted, although the amount collected may increase. The government has also reestablished the Tax Tribunal, a court specialized in hearing tax issues.

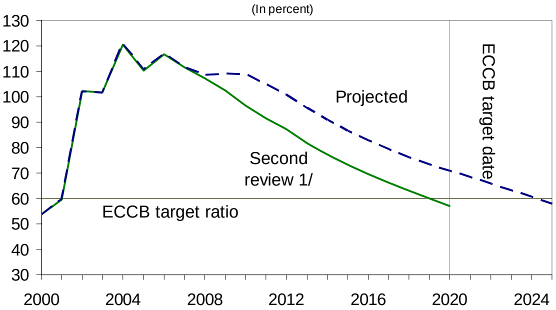
- On the expenditure side: freezing wages for public service workers;[13] targeting capital expenditure as described above; and increasing the efficiency of spending on goods and services, supported by the new Waste Reduction Unit.

17. **These developments have necessitated a revision in the fiscal framework for 2009.** Given the size of the shortfall in revenue, the measures described above will not be sufficient to meet the end-June 2009 target for the primary balance excluding grants. The government has proposed increasing the primary deficit excluding grants target for end-June from EC$28 million (1.6 percent of GDP) to EC$53 million (2.9 percent of GDP), while proposing an end-November target of EC$78 million (4.3 percent of GDP).[14] This target would still imply an adjustment in the below-the-line primary deficit of nearly 2 percentage points of GDP from 2008 to 2009. The government plans to maintain domestic arrears older than 60 days close to the low level achieved at the end of 2008.

18. **The government has sought additional budget financing to cover the remaining gap after the expenditure reductions.** In addition to arranging a syndicated loan from domestic commercial banks, the government has approached the Caribbean Development Bank (CDB) and World Bank for budgetary support loans.[15] Staff is supporting the authorities' request to raise the concessionality of borrowing from the CDB, and will coordinate with the CDB and World Bank on reform programs attached to the loans.

19. **The debt-to-GDP ratio is not expected to fall below 60 percent by the ECCB's target date of 2020.** Under the revised framework with lower GDP growth and higher debt financing, the debt-to-GDP ratio is not expected to reach 60 percent until 2024. According to the updated Debt Sustainability Analysis (DSA) (Supplement 1), Grenada's debt trajectory has deteriorated since the previous DSA, and Grenada remains at high risk of debt distress. The debt service burden will increase in 2009, reflecting the end of the grace period on obligations to commercial banks restructured in 2005, and the step up in the interest rate from 1 to 2.5 percent on restructured debt to other parties.

Grenada: Evolution of Debt-to-GDP Ratio
(In percent)



Sources: Ministry of Finance; and Fund staff estimates and projections.
1/ Based upon the second review trajectory for GDP.

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[13] A new public sector wage agreement for 2009–11 had been due for negotiation.

[14] An end-November target for the performance criterion will allow sufficient time to complete the fifth review before the end of the PRGF arrangement on April 16, 2010.

[15] The fiscal framework assumes that during 2009–10, Grenada will receive US$12 million in budgetary support from the CDB and US$8 million from the World Bank.

20. **The government is considering a US$50–80 million (7–12 percent of GDP) concessional loan from the Export-Import Bank of China to build a luxury hotel in a joint venture, which they may structure as a public-private partnership (PPP).**[16] The authorities believe that government intervention to move this project forward is necessary to stimulate economic activity in the short run and to boost the economy in the long run. The mission noted that such a PPP, which would atypically be primarily government financed, carried operational and commercial risks in an area typically left to the private sector. The mission noted that with an already high debt level (108.6 percent of GDP at end-2008), such a large loan would undermine the authorities' debt reduction objective. The DSA indicates that an US$80 million loan would increase the present value of the debt-to-GDP ratio by around 5 percentage points in the medium-term (2009–14), even assuming the project led to higher growth. The program's ceiling on bilateral concessional borrowing does not accommodate this loan.

B. Structural Reforms

21. **The government intends to move forward with structural reforms, while sharpening their focus in light of capacity constraints.** These reforms are important not only to overcome the economic crisis in the near term but also to lay the basis for long-term sustained growth by improving competitiveness and promoting private sector-led growth. Major areas of structural reforms are tax and customs reform, enhancing the business environment, improving economic management, and laying the groundwork for a comprehensive poverty reduction strategy.

Structural Benchmarks for the Fourth Review

	Target Date	Status
Recruit and begin training staff and adopt transitional procedures for bonded warehouses	May 2009	Benchmark
Complete the Country Poverty Assessment	August 2009	Proposed Benchmark
Submit the new Excise Bill to Parliament	August 2009	Proposed Benchmark
Develop and begin implementing a customs Fraud Control Plan	August 2009	Benchmark
Establish a Public Procurement Authority	September 2009	Benchmark
Appoint a separate Registrar of Companies	October 2009	Proposed Benchmark

- **The mission welcomed the planned introduction of a VAT in February 2010, which is expected to improve the efficiency of the tax system as it has in other ECCU countries.** The authorities have finalized the policy issues, and also begun work on public awareness and education. They plan to recruit and begin training staff, and to adopt transitional procedures for bonded warehouses by May 2009. They are drawing on CARTAC technical assistance on implementation. The new VAT and Excise Bills are expected to be passed by Parliament in May and August 2009, respectively. The mission urged the authorities to adhere to the established schedule for VAT implementation.

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[16] The legal and regulatory framework to facilitate a PPP would need to be enhanced. The government is not actively considering a possible loan to build a marina and port.

- **Work toward introducing a market-based property tax now underway will also enhance revenue and the effectiveness of the tax system.** The cadastral survey, which will provide the basis for reassessing the value of property, is expected to be completed in the near future. The introduction of new valuations may be delayed until January 2011 to avoid introducing two major tax reforms in the same year.

- **The customs Fraud Control Plan, to be developed and implemented by August 2009, is an important part of the customs reform strategy.** This plan will lay the basis for risk-based inspections, which together with a new information technology system planned for 2010, will improve customs revenue and efficiency. The plan is part of a broader strategy to enhance the efficiency and effectiveness of the Ports and Customs Authorities, as discussed in a recent national consultation.

- **The government is developing an action plan to improve Doing Business Indicators, with technical assistance from the World Bank.** Five priority areas have been identified: starting a business, trading across borders, paying taxes, registering property, and enforcement of contracts. Appointment of a separate Registrar of Companies, which is expected to be an important component of a one-stop shop for business start-ups, has been identified as a structural benchmark to be completed by October 2009 for the fourth review.

- **The Country Poverty Assessment (CPA) will provide essential information to improve targeting of social programs, and to develop a comprehensive poverty reduction strategy.** A summary of key findings was submitted to Cabinet in May 2009, and the structural benchmark on completing the CPA has been rephased for August 2009. The authorities will build on this assessment, together with an earlier National Development Strategy, to finalize a full PRSP by November 2009.

- **A major reform of the Ministry of Finance is aimed at improving the capacity for economic management.** The new Debt Management Unit is already making progress with plans to improve debt monitoring and the capacity to assess debt sustainability. The new Private Sector Development Office has also reinvigorated efforts to improve the business environment. A Waste Reduction Unit has recently been established to reduce wasteful spending. Plans are also underway to create a Division of Economic Management and Planning to sharpen the analytical underpinnings of the policy framework and a Public Procurement Authority to enhance the quality, integrity, and transparency of public procurement.

22. **The resolution of Capital Bank will proceed once the High Court has ruled on the legal challenges by the bank's owner.** The authorities are appropriately considering options to address the owner's legal challenges. The delay in resolving the bank partly reflects weaknesses in the legal framework and the court's limited experience with such cases. Given the passage of time and the diminution of assets, the mission recommended that the government proceed immediately to liquidate the bank once the legal obstacles are overcome.

23. **The authorities are working to address financial sector uncertainty stemming from the intervention of CL Financial Group.** Regional leaders have moved to establish a "Liquidity Support Fund" for British American Insurance, an insurance subsidiary of CL Financial Group, and to coordinate regional information sharing and response planning.[17] In addition, the Grenada Authority for the Regulation of Financial Institutions (GARFIN) has prohibited the two insurance subsidiaries of CL Financial Group operating in Grenada from offering deposit-like products with high interest rates. Parliament is expected to pass the new Insurance Act by end-June 2009, and its consideration has been expedited in light of the circumstances.

24. **The global and regional financial turmoil have heightened the need to further strengthen nonbank financial sector regulation and supervision.** GARFIN is continuing efforts to develop its capacity, with assistance from CARTAC, and is enhancing legislation, producing regulations, and developing and implementing supervisory practices. It is tightening supervision over credit unions, and has pursued a strategy of consolidation to create a sector with fewer, stronger institutions. The government submitted the Money Services Act to Parliament in March 2009, and plans to submit the Cooperative Societies Act in June 2009.

IV. Program Issues

A. Program Design

25. **The attached Letter of Intent and accompanying Supplementary Memorandum of Economic Policies outline the authorities' policy objectives for the remainder of 2009.** They have proposed relaxing the end-June 2009 performance criterion on the primary balance excluding grants. Quantitative performance criteria for end-June and end-November 2009 and structural measures are shown in Tables 1 and 2 of Attachment II. The authorities expect to complete the benchmark for the third review on submitting investment incentives legislation by end-May. The benchmarks on submitting the new Excise Bill to Parliament and completing the Country Poverty Assessment have been rephased to August 2009.

[17] The ECCU members' joint contribution to the Fund would be US$10 million. Regional leaders, together with the ECCB, are working out the modalities for this contribution. The program incorporates an adjustor on the primary fiscal balance and net credit targets for potential insurance sector support.

26. **The authorities have requested an augmentation (37.5 percent of quota) of the access under the PRGF Arrangement to help mitigate the adverse effects of the tourism and FDI shock**. Tourism receipts and FDI are expected to fall by US$16 million (3 percentage points of GDP) and US$59 million (10 percentage points of GDP), respectively (see text table). Exports and private transfers are also projected to decline. The reduction in imports due to exogenous factors, on account of lower FDI (US$42 million) and of lower food and fuel prices (US$16 million), will not fully offset these projected declines, giving rise to a financing gap of US$11.6 million. To cushion the balance of payments impact, the authorities have requested that an additional SDR 4.39 million (around US$6.5 million) be disbursed at the conclusion of the third and fourth reviews in equal amounts.[18] This augmentation would increase access from 102.5 to 140 percent of quota, which would be in line with the new access norm for first-time PRGF users.[19]

Grenada: Estimated Net Impact of Tourism and FDI Shock

	2008	2009	Difference
	(In millions of U.S. dollars)		
Current account	-269.9	-214.1	55.8
Of which:			
(A) Exports	33.0	32.7	-0.3
(B) Imports	-339.5	-264.1	75.4
Of which:			
(C) FDI-related (both fuel and nonfuel	…	…	41.8
(D) Fuel and food (price effect)	…	…	16.1
(E) Endogenous adjustment	…	…	17.4
(F) Travel (net)	112.0	96.1	-16.0
Of which: Receipts	128.6	112.1	-16.5
(G) Private transfers	19.2	17.4	-1.9
Capital and financial account 1/	257.9	182.7	-75.3
(H) *Of which:* Direct investment (net)	161.2	102.3	-58.9
Overall balance	-12.0	-31.5	…
Financing	12.0	19.8	…
Of which:			
Change in imputed reserves	6.4	10.3	…
Requested augmentation	…	6.5	…
(I) Gross impact (A+F+G+H)	…	…	-77.0
(J) Net impact (I+C+D)	…	…	-19.1
Memorandum items:	(In percent of GDP)		
Central government operations			
Total revenue and grants	31.3	26.7	-4.5
Of which: Current revenue	26.9	24.2	-2.7
Total expenditure	37.0	31.6	-5.4
Overall balance	-5.7	-4.9	0.9
Financing			
Of which:			
Net external financing	2.6	2.3	…
Net domestic financing	-0.2	1.2	…
Requested augmentation	…	1.0	…

Source: Grenada authorities; and Fund staff estimates.
1/ Includes net errors and omissions.

B. Program Risks and Financing Assurances

27. **The program faces significant risks, notwithstanding the authorities' demonstrated policy commitment.** A more pronounced and prolonged global slowdown could further reduce tourism demand and FDI inflows, which would deepen the economic downturn and lower revenue; lower donor grants and increased financial sector vulnerability are additional risks. The program incorporates adjustors on grants and on insurance sector support, as well as a more focused structural agenda. The authorities are committed to taking contingent measures if needed to reduce spending, including limiting transfers. The possible US$50–80 million (7–12 percent of GDP) concessional loan from the Export-Import Bank of China, which is now being considered, has not been accommodated under the program's ceiling on the contracting and guaranteeing of bilateral concessional external debt.

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[18] The remainder of the gap would be filled by possible reschedulings from the Paris Club and Taiwan Province of China.

[19] See Press Release No. 09/138.

28. **The authorities have approached the Paris Club for an extension of the 2006-08 debt rescheduling treatment to include 2009.** An extension would be useful in the tight external financing environment. The authorities are continuing to seek a settlement with the Export-Import Bank of Taiwan Province of China on terms comparable to that provided by the Paris Club. The authorities are also continuing to make best efforts to conclude the remaining bilateral Paris Club agreement with the Russian Federation and to offer those nonparticipating creditors in the 2005 commercial debt exchange who come forward the same terms as received by other participants in the exchange. The authorities have cleared all but EC$1 million in arrears on unrestructured domestic debt to the nonbank public incurred in June 2007, while there are EC$1.7 million arrears on 90-day treasury bills held by domestic commercial banks.

V. Staff Appraisal

29. **Grenada, like the rest of ECCU and the Caribbean, has been hit hard by negative spillovers from the global economic downturn.** Its financial system has come under pressure, primarily through the nonbank sector. The very high debt levels in the context of the regional currency board arrangement greatly constrain policy responses to the downturn.

30. **The government is approaching these challenges with a strong resolve.** After the strong fiscal adjustment in the second half of 2008 and progress with structural reforms, Grenada is now better placed to weather the difficult period ahead. The government is applying the same determination in 2009 in its response to the shock to tourism and FDI buffeting the country.

31. **Staff welcomes the government's steps to address the worsened circumstances.** The government is reducing capital spending, imposing a wage freeze, and increasing the efficiency of spending on goods and services in response to significant revenue shortfalls. At the same time, it is seeking to get the greatest economic stimulus possible within the tighter budget envelope by accelerating a list of priority projects. The fiscal framework accommodates additional targeted transfers to assist vulnerable segments of the population. In light of the risks to these groups, staff has underscored the need to complete the Country Poverty Assessment without further delay.

32. **The ambitious program of fiscal reform is moving forward.** Introduction of a VAT will enhance the coverage and buoyancy of the tax system. It will be important to continue with the thorough approach being taken with preparations, and passage of new VAT and Excise Bills will be a crucial step. Progress with the cadastral survey is laying the basis for a market-based property tax, which has appropriately been delayed until January 2011 to avoid taking on two major tax reforms in the same year.

33. **Improving economic management through institutional reform at the Ministry of Finance is a welcome priority.** Notable progress has already been made by the new Debt Management Unit and Private Sector Development Office. The creation of a Waste Reduction Unit, a Division of Economic Management and Planning, and the planned Public Procurement Authority are also welcome innovations.

34. **Caution is warranted regarding the possible loan from the Export-Import Bank of China to build a luxury hotel.** While acknowledging the authorities' desire to stimulate the economy, staff has cautioned that a loan of this magnitude would undermine progress toward debt sustainability and entails significant implementation risks.

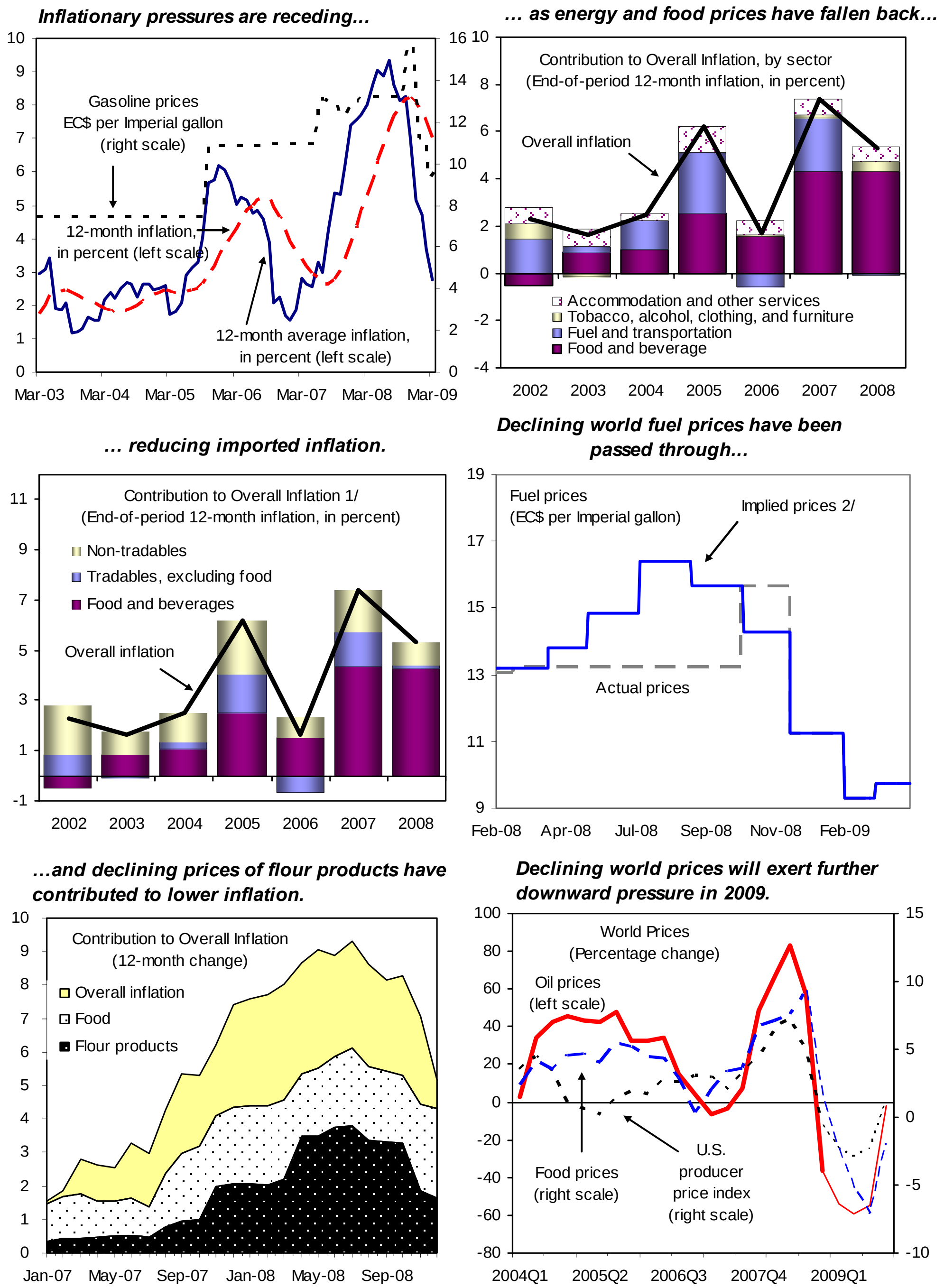
35. **Improving tax enforcement and detection powers is essential following completion of the tax amnesty.** The government decided to extend the tax amnesty to end-April only for those who had already approached the government by end-March but needed more time to complete the administrative process. Staff welcomes the tax administration's plans to employ their capacity to garnish income and to seize assets.

36. **The authorities need to carefully monitor financial sector vulnerabilities.** The banking sector has remained resilient. However, concerns regarding CL Financial Group, which follow upon past difficulties of Capital Bank and an unregulated investment scheme, could pose a risk to confidence in the financial system. Staff welcomes the close cooperation among regional governments to address the troubled CL Financial Group. The government's decisions to revoke Capital Bank's license and to petition the High Court for liquidation are laudable, and the government should proceed directly to liquidation once the court permits. GARFIN needs to continue improving its capacity for nonbank financial supervision and regulation.

37. **The deteriorating environment has heightened program risks**. Key risks include the potential of a deeper and more prolonged global downturn, uncertainty regarding CL Financial Group, and the possible large loan from the Export-Import Bank of China. The government has responded prudently thus far to the first risk by prioritizing spending plans, enhancing efforts to protect vulnerable groups, and identifying contingent measures. The program's design seeks to address risks, through the identification of contingent fiscal measures, the ceiling on bilateral concessional debt, and adjustors on grants and on insurance sector support.

38. **Notwithstanding these risks, staff supports the authorities' requests for completion of the third review and financing assurances review, for modification of a quantitative performance criterion, and for augmentation.** The government has shown an impressive commitment to its program. Staff supports the government's efforts, while underscoring the need for perseverance and caution as pressures intensify.

Figure 1. Grenada: Inflation Developments



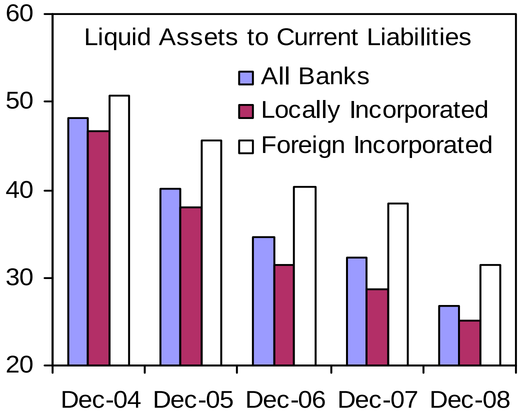
Sources: Grenada authorities; Bloomberg; ECCU; IMF, International Financial Statistics; IMF, World Economic Outlook; and Fund staff calculations.

1/ Tradables comprise food, alcoholic drinks and tobacco, fuel and light, clothing and footwear, household and furniture equipment. Nontradables include medical care and expenses, education, personal services, housing and utilities, and transportation and communication.

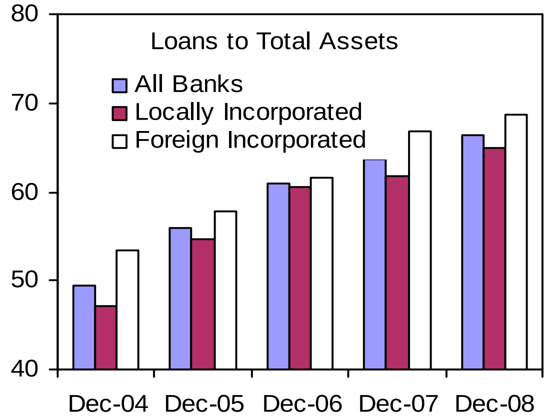
2/ Prices implied by the automatic pricing mechanism and assuming the EC$3 per gallon specific fuel tax was in place.

Figure 2. Grenada: Banking System Vulnerabilities

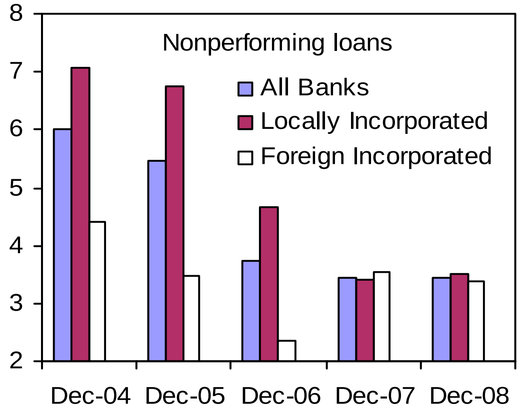
Though liquidity conditions have tightened...



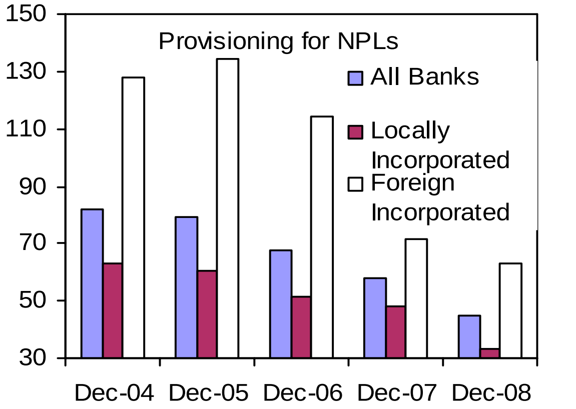
...banks have continued shifting their assets toward loans...



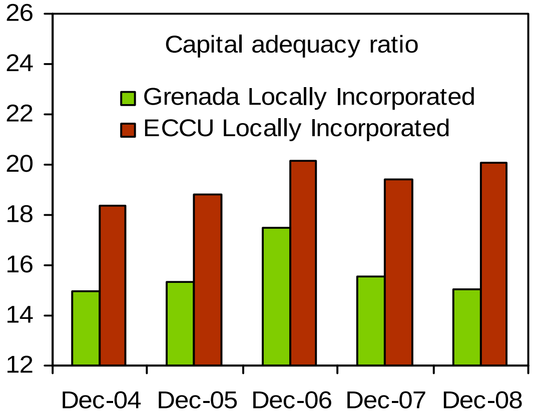
...and NPL ratios have remained at moderate levels...



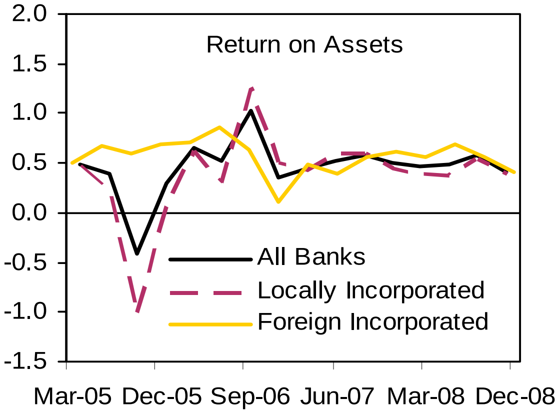
...but the declining trend in provisioning points to the need for vigilance in the banking sector.



Capital cushions in local banks remained solid, despite their recent decline...

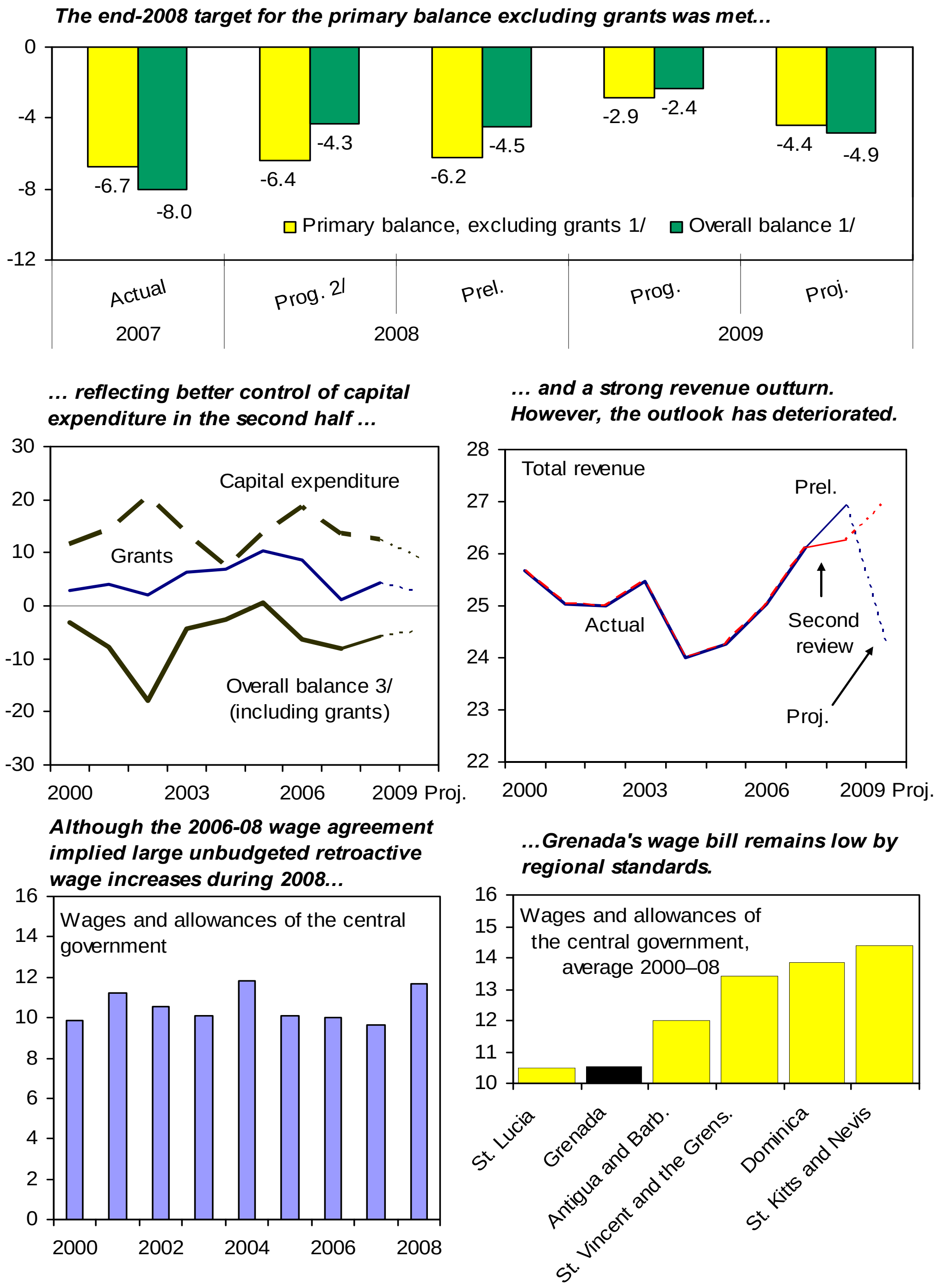


...while bank profitability has remained stable.



Sources: ECCB; and Fund staff calculations.

Figure 3. Grenada: Fiscal Sector Indicators
(In percent of GDP)



Sources: Grenada authorities; ECCU country authorities; and Fund staff estimates.
1/ Measured below the line.
2/ The target for the primary balance excluding grants is adjusted based on the outturn for grants, concessional loans, and bank restructuring costs.
3/ Includes 11.4 percent of GDP paid in 2002 to extinguish lease arrangements.